**Effective Date:** June 3, 1997

# COORDINATED ISSUE
# UTILITIES INDUSTRY
# INVESTMENT CREDIT ON TRANSITION PROPERTY

## ISSUES:

1. Whether the "regulatory compact" or franchise under which a regulated public utility operates qualifies as a binding written supply or service contract under section 204(a)(3) of the Tax Reform Act of 1986?

2. Whether the specifications and amounts of property necessary to provide utility services and/or goods in years after 1985 are readily ascertainable from the budget projections of a public utility and are these projections "related documents?"

3. What are the placed in service dates for transition property qualifying under section 204(a)(3) of the Tax Reform Act of 1986?

## CONCLUSIONS:

1. Transition rules are applied narrowly. State law must be consulted to determine whether the regulatory compact or franchise of the utility is even considered a contract. However, even if the franchise is considered a contract, it may not be a written contract because all its terms may not be set forth in writing. Nor is it binding because its terms, most often the price to be charged, can be changed by the state or municipality. Finally, the franchise is not a supply or service contract as contemplated by Congress under the transition rule because it establishes reciprocal obligations other than to provide a service or supply for a given price. Instead, it grants the exclusive right to service or supply an area in return for the obligation to service or supply that area.

2. In general, utility budget projections are formulated long after the "regulatory compacts" or franchises were established; they are not part of that commitment process; and they are not sufficiently related to the franchise to serve as the basis for allowing the benefit under the transition rules. In any event, budget projections are mere cost estimates subject to change. They do not provide sufficient information to readily ascertain both the type and amount of property that will be required to conduct future utility operations.

3. The applicable placed in service date for property that otherwise qualifies for transition relief under section 204(a)(3) depends on the type of property involved. See I.R.C. § 49(e)(1)

**SCOPE:**

This paper addresses claims by investor–owned regulated public utilities for additional investment tax credit [ITC] for the years 1986 through 1990. These claims are based upon the theory that all, or almost all, of the personal property placed in service in those years meets the "written supply or service contract" exception to the repeal of ITC and thereby qualifies as "transition property."

**FACTS:**

This paper is intended to cover regulated public utilities engaged principally in the generation, purchase, transmission, distribution, and/or sale of electric, gas, telephone, water or sewer services. A public utility is regulated by state and/or local authorities.

State and local governments have regulated the utility industry since the late 1800's. Some form of state regulation of utilities now exists in all states. Each of the states has a commission empowered by statute to regulate utilities that render retail service to the public in the jurisdiction. The commission usually has broad powers of general supervision over such utilities, including the power to regulate their rates and practices and, in appropriate circumstances, to compel service or to make correction for inadequate or unauthorized service. Properly issued orders of the commission are enforceable by law, and violations of such orders and of the public utility laws of the state usually are punishable. Final orders of the commission are appealable in the state courts and, if federal questions are involved, in the federal courts.

Currently, every one of the 50 states has state laws that set up exclusive retail marketing areas for investor-owned utilities.[1] These laws and regulations take two forms. First, some commission-administered state laws specifically provide for service area assignments, i.e., territorial-type statutes. These statutes frequently specify their purposes as: avoiding expensive duplication of facilities, improving efficiency, and minimizing service area disputes. Typically, these territorial-type statutes explicitly provide that the utility has the exclusive right and obligation to serve an identifiable service area.

Second, in at least 38 states, service area assignments are made pursuant to so called "certificate of public convenience and necessity" statutes. These statutes do not

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1Much of the following discussion on state laws dealing with utility franchise areas is based upon Samuel Porter and John Burton, "Legal and Regulatory Constraints on Competition in Electric Power Supply," Public Utilities Fortnightly (May 25, 1989): 24-36.

expressly designate an exclusive service territory, but instead employ the certificates to assign retail service areas, normally evidencing an intention to have only one supplier in a service area. Often these statutes specify that they are meant to avoid duplication of facilities and to prohibit an entity from unreasonably interfering with existing utility service. New Mexico's Certificate of Convenience and Necessity law is representative of this type of statute.[2]

But, state territorial and certificate of convenience and necessity laws do not exist in isolation. They are part of what both legal scholars and utility practitioners recognize as the "regulatory compact." While the exact details of this compact vary in minor ways from state to state, the "regulatory compact" provides for the rights and responsibilities of regulated public utilities. Public utilities have the opportunity to collect a reasonable price for their services based on their prudently incurred expenses and a reasonable return on prudent investments that are used and useful in providing service. Further, utilities have the right to impose reasonable rules and regulations on their customers. When providing adequate service at reasonable prices, utilities have the right to some protection against competition in their service areas. Finally, most utilities enjoy the right of eminent domain. See Charles Phillips, The Regulation of Public Utilities (Arlington, VA: Public Utilities Reports, Inc., 1985), 106-107.

In exchange for these rights, utilities have certain responsibilities. First, they have an obligation to serve all who apply for service from within their service area. Second, they must provide safe and reliable service. Third, they must not engage in undue price discrimination. In other words, all similarly situated customers receiving the identical service must be served on the same terms and conditions and for the same price. Public utilities can only charge just and reasonable rates and cannot earn monopoly profits. Also, it is important to note that the "regulatory compact" is not necessarily an agreement that utilities have voluntarily accepted. The regulatory compact is instead often a balancing of utility rights and responsibilities, enacted by state legislatures and enforced by state public service commissions. When the regulatory compact is fundamentally changed, as would be the case if retail wheeling is permitted, then a fundamentally new regulatory compact with a new balancing of utility rights and responsibilities would be needed. See Charles Phillips, The Regulation of Public Utilities (Arlington, VA: Public Utilities Reports, Inc., 1985), 106-107.

**LAW:**

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2N.M. Stat. Ann. sec. 62-9-1 et seq. (1984 & 1987).

Summary:

The Tax Reform Act of 1986 (Act) terminated the regular percentage investment tax credit (ITC) effective for tax years beginning after December 31, 1985. In eliminating ITC, Congress created a number of transitional rules to provide relief to taxpayers who were in various phases of construction, reconstruction, or acquisition of personal property and likely would have made financial commitments on the assumption that ITC would be available.

One of the general rules provided that taxpayers with written supply or service contracts would be excepted from the termination of the ITC for a transition period. This exception required that a taxpayer have a binding written supply or service contract as of December 31, 1985, and that the ITC property be necessary to fulfill the contract and be readily identifiable from the contract or related documents. The "written supply or service contract" rules are at issue in this position paper.

Statutes:

Section 49(a), as added by section 211(a) of the Act, provides that the 10 percent regular ITC does not apply to property placed in service after December 31, 1985. Section 49(b)(1) provides that the repeal does not apply to "transition property" as defined in section 49(e), subject to the general limitations in sections 49(c) and (d).

Section 49(e)(1) defines the term "transition property" as any property placed in service after December 31, 1985, to which the amendments made by section 201 of the Act (the modification of ACRS) do not apply, with the substitution of the earlier effective date of December 31, 1985, in applying section 204(a)(3) of the Act and provides specific placed in service dates. In order to satisfy the transitional rules under section 49(e), property must satisfy both the specific effective date requirement and be placed in service by a specified date depending on the property's class life.

Section 203(b)(2)(C)(ii) of the Act further modifies property described in section 204(a) by allowing a special exception. This exception provides that property with a class life of at least 7 years but less than 20 years shall be treated as having a class life of 20 years. This provision therefore provides for a December 31, 1990, placement in service date for property that has a 7 year or longer class life and that is related to a written supply or service contract.

Conference Report No. 99-841, 99th Cong., 2nd Sess. II-55, 1986-3 (Vol. 4) C.B. 55, states that the general binding contract rule applies only to contracts in which the construction, reconstruction, erection, or acquisition of property is itself the subject matter of the contract. Moreover, a contract is to be considered binding only if it is enforceable under state law and does not limit damages to a specified amount, such as

by a liquidated damages provision. However, a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price is not treated as limiting damages.[3]

Section 204(a)(3) of the Act, as modified by section 49(e)(1)(B), provides transition relief to "any property which is readily identifiable with and necessary to carry out a written supply or service contract, or agreement to lease, that was binding on" December 31, 1985.

The Conference Report at II-59-60, 1986-3 (Vol. 4) C.B. 59-60, also discusses the transition relief in section 204(a)(3) of the Act as applying in those situations in which written binding contracts require the construction or acquisition of property, but the contract is not between the person who will own the property and the person who will construct or supply the property. According to the Conference Report, this transition rule applies to written service or supply contracts and agreements to lease entered into before January 1, 1986. The supply or service contract rule is applicable only where the specifications and amount of property are readily ascertainable from the terms of the contract, or from related documents. A written supply or service contract or agreement to lease must satisfy the requirements of a binding contract. This rule does not provide transition relief to property in addition to that covered under a contract described above, which additional property is included in the same project but does not otherwise qualify for transition relief.

There is no additional specific guidance in the Conference Report, House Report, or Senate Report concerning the interpretation of the requirements of the written service or supply contract transitional rule.

ANALYSIS:

The utility industry has taken the position that any "regulatory compact" or franchise in existence as of December 31, 1985, qualifies as a written supply or service contract enforceable under state law and described in section 204(a)(3) of the Act. Additionally, the industry asserts that all property installed pursuant to any of these types of "contracts" will qualify as property "readily identifiable and necessary to carry out" the terms of these "contracts," asserting that the internal plans and projections for future additions, replacements, upgrades, etc., constitute documents "related to" these

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3To date, no cases have been decided on the "binding contract" transition rule in the 1986 Act. There are decided cases, however, on the binding contract transition rule contained in the 1969 Act. These cases held that the agreement must be definite and certain so that the promises and performances to be rendered by each party are reasonably certain. See Sartori v. Commissioner, 66 T.C. 680 (1977) and Sudbury Textile Mills, Inc. v. Commissioner, 68 T.C. 528 (1977).

"contracts" and adequately specify the property to be acquired. This expansive interpretation goes far beyond the intent of Congress in grandfathering certain types of projects for transitional relief.

Issue 1:

Whether the "regulatory compact" or franchise under which a regulated public utility operates qualifies as a binding written supply or service contract under section 204(a)(3) of the Act?

Although the Tax Reform Act of 1986 provides ITC transition property treatment to a "written supply or service contract," it fails to define the term. We believe that Congress did not intend that a written supply or service contract for purposes of section 204(a)(3) would include the typical regulatory compact or franchise under which a public utility operates. Rather, Congress intended for a narrow meaning of that phrase as courts have long held that transition rules offering tax credits are to be strictly construed.

In a recently decided case, United States v. Kjellstrom, 916 F. Supp. 902, 905 (W.D. Wis.), aff'd, 100 F.3d 482 (7th Cir. 1996),[4] the district court stated that the ITC transition rules associated with the Tax Reform Act of 1986 are to be narrowly construed:

> Although the investment tax credit was intended to be construed liberally and included a provision to that effect, the general rule is that transition rules offering tax credits are to be construed strictly in accordance with Congress' intent. Helvering v. Northwest Steel Mills, 311 U.S. 46, 49 (1940) (provisions of tax statutes granting exemptions are to be strictly construed). See also United States v. Hemme, 476 U.S. 558, 566 (1986) (court will not impute to Congress an unstated intention); Commissioner v. Drovers Journal Pub. Co., 135 F.2d 276, 278 (7th Cir. 1943) (deductions from gross income must be construed narrowly and strictly). Because tax deductions and credits are within the discretion of the legislature, the courts will not expand them beyond what Congress has intended. See New Colonial v. Helvering, 292 U.S. 435, 440 (1934) (deductions depend on legislative grace); Commissioner v. Fiske's Estate, 128 F.2d

4The Seventh Circuit decided the case against the taxpayer on the "world headquarters" issue and did not address the transition rule for the placed in service issue.

> 487, 489 (7th Cir.), cert. denied, 317 U.S. 635 (1942) (deductions are narrowly construed).

Even if one could characterize the public utility "regulatory compact" or franchise as being a binding contract, the utilities' attempts to classify such a "contract" as a "written service or supply contract," as that term is used in ITC transition rules is, at best, shallow-rooted. We believe that the industry's construction of "supply or service contract" is overexpansive and contrary to the intent of Congress.

For one thing, the regulatory compact or franchise of a public utility is not a supply or service contract in the sense that it does not require the exchange of a specific service or supply for a stated price or compensation. Rather, this regulatory compact merely imposes an obligation on the utility by law to supply or service a particular area at the request of customers in exchange for the exclusive right to do so plus a reasonable rate of return. The agreement between the customer and the utility is more characteristic of a classic service or supply contract.

Moreover, in subdivisions (5) through (33) of Act section 204(a), among the numerous specific exemptions from repeal are several for utilities. If, as contended by the utilities, the franchises, licenses and/or tariffs of utilities actually were, in the view of Congress, "supply or service contracts", those special exemptions would be rendered both superfluous and redundant as they would already be grandfathered under section 204(a)(3).

In Kjellstrom, 916 F. Supp. at 907, the district court discussed congressional intent with respect to the "world headquarters" ITC transition rule and stated as follows:

> It would run counter to Congress's clear intent to interpret section 204(a)(7) as applying to any company that enters into a lease agreement prior to September 26, 1985 for a building that can be labeled a world headquarters. Transition rules were intended to provide limited exemptions for certain taxpayers who would be affected adversely by a new law because they had relied on the old law to their detriment. Section 204(a)(7) provides transitional relief for companies like Merrill Lynch that entered into a new lease for the construction of a building with the understanding that certain depreciable property would be exempt from taxation. By contrast, Wisco signed its lease back in 1974 and did not rely detrimentally on the old law. Wisco cannot argue reasonably that it had an expectation interest that the provisions of the old law would never be repealed.

We believe, in a similar manner, that congressional intent associated with the "written supply or service contract" rule was not to include public utility "regulatory compacts" or franchises. Since public utilities established these "regulatory compacts" or franchises many years ago, it is obvious that they could not have relied detrimentally on the "old law." Consequently, a public utility cannot argue reasonably that it had an expectation interest that the provisions of the old law would never be repealed. Moreover, a utility is generally able to pass any increase in tax through to its customers.

It is implausible that Congress would have intended to grant wholesale exemptions from the repeal of the ITC upon the basis of very old "contracts," some of which can be aptly described as ancient, without making the intention to do so very clear. No detrimental reliance on the ITC is exhibited in the franchise or other documents that would warrant transition relief. On the contrary, the utility will and must acquire the property as part of its overall operations unrelated to the tax benefits attendant thereto. The acquisition of the property is not because of any "supply or service contract" but the raison d'etre of the utility's existence. Thus, under the utilities' expansive interpretation, the exception (transitional relief) would swallow the rule (repeal of the ITC), contrary to the mandate that these rules be strictly and narrowly construed.

Public utilities argue further that the legislative history shows that the "written supply or service contract" exception clearly applied to "public franchises," noting the conference report reference to cable TV franchise agreements and congressional colloquies explaining "service contract." The conference report states at 1986-3 (Vol. 4) C.B. 60, "The conferees wish to clarify that this rule applies to cable television franchise agreements embodied in whole or in part in municipal ordinances or similar enactments before March 2, 1986 (January 1, 1986, for the investment tax credit.)"

The above conference report was discussed with respect to cable television franchises in a colloquy between Senators Glenn and Packwood in 132 Cong. Rec. S13,955 (daily ed. Sept. 27, 1986). Senator Packwood stated:

> It was the intent of the conferees, as indicated in the conference report, that the definitive franchise agreement which was contemplated by the July 1985, ordinance would be considered embodied in that ordinance and as such would qualify as a supply or service contract entered into prior to March 2, 1986, with respect to the depreciation rules and January 1, 1986, in the case of the investment tax credit rules. [Underscoring supplied.]

We believe that the legislative history cited by the public utilities does not stand for the proposition that all public franchises meet the "written supply or service contract"

exception. Further, we do not read the legislative history to state that all cable television franchises meet this exception. We believe that the import of the legislative history is that the fact that a cable television franchise agreement later became part of a municipal statutory arrangement does not preclude that franchise agreement from qualifying for this exception. However, there first must have been an agreement, and that agreement must have been definitive, not vague or general.

Further, cable TV is distinguishable from regulated franchised utilities. The Cable Communications Policy Act of 1984 (See 47 U.S.C. section 541(c)) explicitly excludes cable systems from regulation as common carriers or utilities. See 47 U.S.C. section 541(c). In fact, cable operators competed and bid for the right to serve various cities and other political divisions and did enter into written (express) contracts to provide cable service and many of those contracts did become embodied in ordinances, resolutions or similar enactments. Inasmuch as the Cable Communications Policy Act of 1984, which took effect at the end of 1984, would have been very fresh in the mind of the legislators, the unique situation of TV cable systems would account for their special mention.[5] Accordingly, we believe that any exception for cable television franchises is limited to cable television franchises and does not extend to all public utilities.

Public utility franchises standing alone fail to meet the requirements of section 204(a)(3) because they are not binding written contracts within the meaning of the ITC transition provisions.

The position of the utilities industry is that any franchise, license, and/or tariff filing in existence as of December 31, 1985, qualifies as a binding written contract under section 204(a)(3). The utilities provide citations from state law in an attempt to show that franchises are considered to be contractual arrangements or contracts. The utilities also assert that tariffs filed with local, state and/or federal governments are also binding written contracts.

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5The cable television franchises were specifically grandfathered in section 202(d)(11) of H.R. 3838 as passed by the Senate on June 24, 1986. Section 202(d)(11) provided, in part, that the amendments made by section 201 would not apply to any property that is readily identifiable with or necessary to carry out a binding obligation with a municipality under an ordinance granting television franchise rights if the ordinance was enacted on July 22, 1985, and a construction contract was signed before April 1, 1986. Although the 1986 Act as enacted did not contain the special carve-out for cable television in section 202(d)(11), the same result was intended to obtain under section 204(a)(3). See the above colloquy between Senators Glenn and Packwood. The inclusion of cable television franchises in section 204(a)(3) may not have interpretive application beyond that industry, but rather appears to be similar to the multitude of "rifle-shot" rules contained throughout section 204(a), wherein congressionally favored entities and industries were given transition relief.

The utilities also suggest that the tariffs they file with various regulatory bodies constitute binding written contracts. But tariffs are not necessarily considered contracts. In 1921, the Supreme Court decided Western Union Telegraph Co. v. Esteve Bros. & Co., 256 U.S. 566, 41 S. Ct. 584 (1921). The issue was whether a sender of a telegram, which, as received, contained a significant error (the number 2,000 was substituted for 200), could recover monetary damages in excess of the amount set forth in the tariff of the telegraph company, which limited damages to the fee charged. The Supreme Court held that the tariff supplanted/superseded the common law liability of the regulated carrier. "Before the (amendment) the (telegraph) companies had a common law liability .... Thereafter, ... the outstanding consideration became that of uniformity and equality of rates."; and concluded: "The rate became, not as before a matter of contract, but a matter of law by which uniform liability was imposed."

Some states may characterize public utility franchises and tariffs as being founded entirely on law while others may characterize them as founded on contract. Where the franchise or regulatory compact of a public utility is not characterized in terms of contracts under state law, taxpayers should not be able to recharacterize these state law arrangements as satisfying the binding written contract precondition to transition relief. We believe, however, that even if state law characterizes a compact as contractual, the compact, franchise, or tariffs are not "written supply or service contracts" within the meaning of the ITC transition rule.

Any contractual arrangement that arises between the utility and a state or municipality pursuant to the franchise is not an express contract in the sense that all the material terms are evidenced by a written instrument agreed to by both parties. Rather, any resulting contractual arrangement is in the nature of an implied contract in which the mutual assent of the parties is inferred from the actions of the parties. Because the transition rule of section 204(a)(3) is limited to certain written contracts, implied contractual arrangements of this sort not fully reduced to writing were not intended by Congress to qualify for the transitional relief.[6]

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6The legal structure establishing a utility's retail service area is usually provided in one of two ways, or a combination thereof: (1) through commission-administered state laws specifically providing for service area assignments - i.e. territorial-type statutes - and (2) through statutes requiring the utility to obtain from the commission a certificate of public convenience and necessity to provide service in the area designated in the certificate. See "Legal and Regulatory Constraints on Competition in Electric Power Supply" Samuel Porter and John Burton, Public Utilities Fortnightly (May 25, 1989). See also Fla. Jur. 2d Energy §37, which states: An express contract is not essential to establish reciprocal rights between a public service company and the public it

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Further, although some utility tariffs set forth in detail the terms of the relationship between regulated utilities and their customers, the tariffs are not binding contracts, even with current customers, because they can be modified without the consent of the customer. Where one party can terminate or modify its promise at will, there is no legal or binding obligation upon it and its promise is, therefore, insufficient consideration for the other party's promise. Corbin on Contracts §§ 265 and 1266 (1962). The tariffs do not qualify as binding written contracts for this additional reason.

The transition relief of section 204(a)(3) applies only to written supply or service contracts binding at the end of 1985. The case law tells us to grant this relief narrowly. Because transition relief was intended for taxpayers who had committed to acquire property in anticipation of the investment credit, it is unavailable to the typical utility that operates under a franchise granted many years ago. Detrimental reliance is lacking. Even if the franchise is considered a contract under state law, it is not a written contract within the meaning of the ITC transition rule. But, more importantly, it is not binding because its terms, most often the price to be charged, can be changed by the state or municipality. Finally, the franchise is not a supply or service contract as it establishes reciprocal obligations other than to provide a service or supply for a given price. Instead, it grants the exclusive right to service or supply an area in return for the obligation to service or supply that area.

Issue 2:

Whether the specifications and amounts of property necessary to provide utility services and/or goods in years after 1985 are readily ascertainable from the budget projections of a public utility and are these projections related documents?

Assuming, arguendo, that a utility "regulatory compact" or franchise is a written supply or service contract, the property that must be acquired to carry out that contract must be readily ascertainable from the contract itself or from related documents. The utilities contend that the construction budget projections they file with utility commissions, typically five-year plans, sufficiently identify the property necessary to provide utility service. We disagree[7].

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6(...continued)
undertakes to serve, since such rights arise by implication of law.

7Indeed, under the utilities' expansive interpretation not only would the entire industry, including electric, natural gas, water, and telephone companies, be grandfathered from the repeal of the ITC, but service companies accounting for a large part of the economy
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The budget projections are mere cost estimates that can be and are modified as conditions change. For example, a natural disaster could cause postponement of a project; cost overruns or delays on one project could delay the start of another project; or changed economic conditions could affect the feasibility of a project. Changes in technology, including new products, also will alter the plans. Likewise, the subsidiary documents used to formulate the budget projections have the same defect -- they are mere projections or approximations.

It is not enough that property purchased is necessary to fulfill the written supply or service contract. To invoke transition relief, the specifications and amount of the property must be readily ascertainable from the contract and related documents in advance of purchase. The specificity requirement serves not only to identify specific property but also serves to identify property required to be purchased. Budget estimates, regardless of their specificity, are inherently inadequate because they merely describe property that may be required, notwithstanding how accurate these estimates eventually turn out to be. They are mere projections that do not commit the utility to purchase the property with respect to which the ITC is being claimed.

That such specificity is required by the transition rules is illustrated by the recent decision in Zeigler Coal Holding Co. v. United States, 934 F. Supp. 292 (S.D. Ill. 1996). The court in Zeigler held that in order for property to be eligible for the ITC under section 204(a)(3) of the Act, the property must be "readily identifiable" with the supply contracts, and "the specifications and amount of the property" must be "readily ascertainable from the terms of the contract, or from related documents." With respect to the specificity requirement associated with the written supply or service contract transition rule, the court stated at 934 F. Supp. at 295:

> [T]o allow a supply contract to implicitly require the acquisition of property, means that the transition rule exception would swallow the rule eliminating the ITC. As a

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of the United States would be eligible as well. Undoubtedly, many of these service companies will have contracts with customers to provide services. All well-managed companies will also have long-range capital expenditure budget projections. Under the utility industries' interpretation of section 204(a)(3), all of these companies would also be eligible for ITC transition relief. Further, manufacturers will have contracts to supply the product they make, coupled with their own capital budget projections, so they would also be grandfathered. The manufacturers' suppliers also would all be eligible, as well as the suppliers of the suppliers, and so on reductio ad absurdum. We find it implausible that the Congress would have, in the thirty-seven words of section 204(a)(3), carved out such a broad reaching exception to the repeal without making this abundantly clear.

> result the Court agrees with plaintiff [Government] that in order to be eligible for ITC, the property must have been specifically described.

Another problem with the budget projections is that they came into existence long after the "regulatory compact" or franchise was established. For this reason, the budget forecasts are not documents sufficiently "related" so as to satisfy the written supply or service contract rules.

Typically, the utility franchises we are concerned with were established many years ago. When the utilities agreed to provide service and or goods, they were not doing so in reliance on the availability of the ITC. Indeed, many of the franchises predate the original passage of the ITC in 1962. As a result, the situations presented are not among those that prompted Congress to provide for transition relief.

A "regulatory compact" or franchise does not specify the property that must be purchased to supply service and/or goods. The utilities contend that problem is cured by their budget projections. However, these budget projections came into being many years later and were not part of the franchise.

At the time the utility committed itself to provide service and/or goods, its needs for years after 1985 were uncertain. While those needs may have become subject to some degree of forecasting in the years leading up to 1986, the commitment to fill those needs grew out of the "regulatory compact" or franchise, not out of the budget projections. Because the budget projections were formulated long after "regulatory compacts" or franchises were established, they are not part of that commitment process and not sufficiently related to the franchise to serve as the basis for allowing the ITC in years after it was unavailable to most taxpayers.

Issue 3:

What are the placed in service dates for transition property qualifying under section 204(a)(3) of the Tax Reform Act of 1986?

Even if property qualifies as transition property, it must meet an additional placement in service requirement under sections 203(b)(2) and 211(e)(1)(C) of the Act, as modified by section 49(e)(1)(C) of the Code. The placement in service requirements are stated in terms of a property's class life. For property whose class life is less than 5 years, the property must have been placed in service by June 30, 1986. For property whose class life exceeds 5 years but is less than 7 years, the property must have been placed in service by December 31, 1986. For property with a class life of at least 7 years but less than 20 years, the property must be placed in service by December 31, 1988. For

property whose class life exceeds 20 years, the property must be placed in service by December 31, 1990.

Section 203(b)(2)(C)(ii) of the Act further modifies property described in section 204(a) by allowing property with a class life of at least 7 years but less than 20 years to be treated as having a class life of 20 years. This provision, therefore, provides for a December 31, 1990, placement in service date for property that qualifies under a written supply or service contract and that has a class life that equals or exceeds 7 years.

Especially noteworthy for telephone utilities is that section 203(b)(2)(C)(i) specifically identifies computer-based telephone central office switching equipment as having a class life of 6 years. Therefore, this equipment was required to be placed in service by December 31, 1986, to qualify as transition property.

Taxpayers argue that all property qualifying under section 204(a)(3) [written supply or service contract] may be placed in service through December 31, 1990. This position was espoused by the taxpayer in Kjellstrom. In that case, the district court determined that section 49(e)(1)(c)(ii) provided that property with a class life of less than 7 years must be placed in service before January 1, 1987. The district court stated at 916 F. Supp at 909:

> However, the fact that § 49(e)(1)(C) does not apply solely to "property described in § 204(a)" does not render ineffective the clear provisions of § 49(e)(1)(C). In addition, § 49(e)(1)(C) applies expressly to "transition property with a class life of *less than 7 years*." 26 U.S.C. § 49(e)(1)(C) (emphasis added). Thus, 49(e)(1)(C)(i)'s requirement that section 203(b)(2) shall apply (and that provision's reference to "property described in § 204(a)" as having a class life of twenty years) cannot include transition property with a class life of less than seven years.

The Kjellstrom case made it clear that property with a class life of less than seven years must be placed in service before January 1, 1987, in order to qualify as ITC transition property. This rule applies even if the property qualifies for transition relief under section 204(a)(3). But see, Airborne Freight Corp. v. United States, __ F. Supp. __ (W.D. Wash. 1996), which concludes that the placed in service requirement for all section 204(a) property is that the property be placed in service by December 31, 1990.

Therefore, it is our position that the following placement in service requirements apply to transition property qualifying under the written supply or service contract rule [section 204(a)(3)]:

1) Property whose class life is less than 5 years must be placed in service by June 30, 1986;

2) Property whose class life exceeds 5 years but is less than 7 years must be placed in service by December 31, 1986;

3) Property whose class life equals or exceeds 7 years must be placed in service by December 31, 1990; and

4) Computer-based telephone central office switching equipment must be placed in service by December 31, 1986.